In the Supreme Court
OF THE
United States

OCTOBER TERM, 1941

No. 1008

J. R. McDONALD, J. R. MASON and MARY E. MORRIS,
Petitioners,

vs.

BANTA CARBONA IRRIGATION DISTRICT,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to the United States Circuit Court of Appeals
for the Ninth Circuit.
and
BRIEF IN SUPPORT THEREOF.

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To the Honorable Harlan Fiske Stone, Chief Justice of the United States, and to the Associate Justices of the Supreme Court of the United States:

Petitioners above named respectfully pray that a writ of certiorari issue to review the judgment entered December 4, 1941 against them by the United States Circuit Court of Appeals for the Ninth Circuit. (R.

389.) The judgment affirmed a decree of the United States District Court for the Northern District of California, Southern Division, dated January 6, 1940, which confirmed a plan of composition of the bonded indebtedness of respondent, Banta Carbona Irrigation District. (R. 108 to 128.) Petition for rehearing was not filed.

Respondent is a California irrigation district or taxing agency, within Section 83 of the Bankruptcy Act. (R. 2.) The proceeding was under that section.

11 U. S. C. A., Section 403;
50 Stats. at L. 653, Chap. 657.

Petitioners hold $36,000.00 in bonds of the District with all interest coupons representing interest accruing after July 1, 1932. (Their claims, R. 84 to 98; testimony as to ownership, R. 234 and 235.) These bonds are affected by the plan of composition. Counting principal and interest, petitioners' loss is over $20,000.00.

The points relied on were both pleaded (R. 35, Par. XIV; R. 45, end of Par. XXII; R. 39, Par. XVII and R. 75, Par. IX and R. 82, Par. XIX) and set out in the statement of points required to be filed by the rules for the Ninth Circuit.

> Point 11 recites (R. 366) that there is no proof that the value of what the plan of composition offered to the appellants equalled what was offered to the principal bondholders, the Reconstruction Finance Corporation (hereinafter called the R.F.C.) and the point recited that the plan discriminated in favor of the R.F.C.

Point 13 explained (R. 366) that the plan proceeded under the theory that the R.F.C. was a bondholder which had consented to the plan, etc.

Point 6 declared (R. 365) that the R.F.C. was not in fact the owner of bonds of the District and was not qualified to give the consent upon which the enforcement of the plan depended.

(The points were stated in this way so as to compel the adoption of one theory or the other with respect to the status of the R.F.C. If, under the arrangement between the R.F.C. and the District, the R.F.C. was to be treated as an owner of the bonds which it held, it became necessary to see that the plan did not accord rights to the R.F.C. which were not accorded to the dissenting bondholders.)

Our contention is that the R.F.C. was found to be such an owner and that it was not under the ruling of the Supreme Court in the *City of Avon Park* case (311 U. S. 138) herein mentioned and of the Circuit Court of Appeals in *Kauffman County Levee Imp. Dist. No. 4 v. Mitchell,* 116 Fed. (2d) 959, qualified to give a consent to a plan of composition which accorded rights to it which were different from those accorded to dissenting bondholders and that the plan was discriminatory and unfair.

SUMMARY STATEMENT OF THE CASE.

The composition petition was filed by the Irrigation District on January 9, 1939. (R. 1 to 29.)

As shown by the petition (R. 1 to 29), the indebtedness involved comprised bonded indebtedness of $1,134,060.00 and warrant indebtedness of $56,895.93 together with interest thereon from July 1, 1932. On December 21, 1938, the unpaid bond interest was $528,853.37 and the unpaid warrant interest was $21,656.23. (R. 12.)

The petition alleges (R. 4) that the District can not meet these debts. We are not inflicting on this Court a review of the evidence as to bankruptcy. We shall point out that the new bonds of the District provide an equity in security of 40%.

The petition alleges that the Reconstruction Finance Corporation owns and holds over 90% of these bonds and warrants and has consented to the District's plan of composition. (R. 5.) The written consent of said corporation to the plan is attached to the petition. (R. 19 to 24.)

(Note that the petition says not one word about compromising any existing loan made to the District by the R.F.C. Yet there was such a loan and it was payable like other debts of the District. Section 83 says that debts of a District payable from the same source are on a par. As will appear, no reference was made in the petition to the "loan" because it was to be settled by compromising the "security" for the "loan", to-wit, bonds and warrants held by the R.F.C. at a figure in new bonds equal to the "loan", and this was

satisfactory to the lender, the R.F.C. A bondholder is of course a lender.)

As will appear, the District's plan provides for the paying to the dissenting bondholders, the petitioners herein, 61 per cent of the principal of their bonds, while at the same time the plan gives to the R.F.C. on account of its interest in the bonds and warrants which it held, 4 per cent tax-free bonds of the District. And for its contribution to a 61 per cent payment to be made for the forced surrender of petitioners' bonds it is to get a like settlement. And there was no proof that the rights so accorded were the same in value. They were legally different.

As will be hereinafter observed, the R.F.C. had before the petition was filed entered into a loan arrangement with the District whereby it advanced funds which, together with certain funds of the District, were used in buying up bonds and warrants of the District in the name of the R.F.C. The arrangement required the passing of the title to the old securities to the R.F.C. and that they should remain in effect to the extent the R.F.C. elected, so that a dissenting bondholder would not be in a position to urge that such taking up of the securities at a discount had freed the District of its bankruptcy. The agreement further stated that the R.F.C. could give any assent necessary to subject all the securities to a bankruptcy plan of composition. It also provided that the R.F.C. should receive interest at 4% per annum on these advances.

As we have indicated, the petition did not state the debt it desired to adjust was but the smaller debt

arising from the advances. Under state law the R.F.C. could not so contract with the District as to make it a creditor for both advances and the old securities jointly purchased. However, the advancing contract which is possibly sustainable in such a situation did provide that the sale of the old securities to the advancer of funds would not settle or discharge them. Somewhat similar arrangements had been previously sustained in handling claims against financially embarrassed concerns. But when the friendly creditor here went into a Bankruptcy Court it could not have its interest in the purchased claims settled on one basis and the claim of a dissenting creditor settled on another basis.

It is elementary that a pledge by a debtor of his own unsecured obligation to secure his debt can not as against his other creditors increase his debts. The rule does not apply to the security that is behind the second debt. The provision for holding the purchased securities in force was to avoid the danger of the rule mentioned. The general rule is well settled. See

Jones v. Sedalia Third Nat. Bank, 13 Fed. (2d) 86,

which case reviewed the authorities.

As the District became liable to the R.F.C. for the latter's advances made to procure the old securities and had to pay interest on such advances, it at least may not be said that if the R.F.C. elected to enforce or settle through bankruptcy or otherwise the old securities which were greater in amount it could also collect the debt for the advances, the whole of the

debts being on a parity. An ordinary debt or a warrant or a bond or a judgment against an irrigation district is collected by causing a tax levy. This is provided in Section 39 of the California Irrigation District Act. And the Court will note that in the original R.F.C. loan resolution here involved the District was required to agree that it would annually levy enough to meet the maturities on the purchased securities but that with the consent of the R.F.C. this could be reduced to the 4 per cent per annum required for the R.F.C.'s advances. We quote:

> "(d) During the time any of the Old Securities are held by or on behalf of this Corporation, the Borrower will annually levy and collect taxes, assessments or other charges and cause the same to be paid over to this Corporation sufficient to pay the principal and interest upon the Old Securities according to their tenor and effect, but the Division Chief may reduce any installment thereof to an amount or amounts not less than may be necessary to pay principal and interest at the rate of 4% per annum on all amounts disbursed by this Corporation to or for the benefit of the Borrower; such payments to be made by the Borrower according to a schedule of maturities satisfactory to the Division Chief." (R. 259.)

The R.F.C. further treated the payment of interest on its advances as a partial payment of the 6 per cent interest called for by the bonds, for in sending in the first interest bill of January 1, 1939, it sent in for cancellation coupons in the same amount. (R. 360, 361.)

The vital question is:

If an Irrigation District agrees with a corporation that the corporation shall advance funds to buy up its bonds and warrants at a discount and that the District shall contribute a portion of the price and that title shall be taken by the corporation to the bonds and warrants purchased and that the District shall have *the privilege* of paying to the corporation *at a time not fixed,* the corporation's advances with interest at 4% per annum and of receiving the securities purchased and that if the "loan" is not paid the corporation shall have the *privilege at a time not fixed* of requiring the District to issue to it 4 per cent bonds of the District for the amount of its advances and that until the old securities bought up are surrendered, the corporation shall have the right to hold them at their full face amount so as to prevent according advantage to dissenting bondholders and that the corportaion shall, while holding the old securities, have the right to consent to a plan of composition of the old securities, is the corporation, under the case of *American United Mut. Life Ins. Co. v. Avon Park,* 311 U. S. 138, 85 L. ed. 91, qualified to consent to a plan of composition which compels the dissenting bondholders to receive cash for their bonds and accords to the corporation 4 per cent tax-free, or any other kind, of bonds of the District for its interest in the bonds and warrants which it holds and for such interest as it will have in the bonds required to be delivered up by dissenting bondholders for a cash

payment which will be the same in amount and which will be provided in manner followed in the purchase of the old securities? Without proof may such a plan be found to be fair and non-discriminatory?

The Court should bear in mind of course that the fact that the plan adopted arranged for issuance of 4 per cent bonds is but a circumstance that enables the other side to argue here that the R.F.C. was entitled to 4 per cent bonds because it had a contract that governed the surrender by it of the bonds which had been bought up. Legally our point is as sound as if the bonds issuable under the plan drew a greater rate of interest than 4 per cent.

The contract could not exclude the effect of bankruptcy. Adroit wording of the loan contract hardly creates a case of bankruptcy so far as dissenting bondholders are concerned and a case of quasi-specific performance so far as an assenting bondholder is concerned. A dissenting bondholder is entitled to what the assenter receives for his interest in the bonds in his hands. The *Avon Park* case shows that, however obscured, discrimination can not be allowed.

The R.F.C. received possession of nearly 90% of the bonds and Section 83 required a two-thirds consent to a plan. It thus had the District bound against any plan that did not suit it. But obviously the security of its position was not under Section 83 an excuse for getting more under the Court's decree, than was accorded to unsold bonds. Bigness of its holding and its governmental creation were immaterial. It

could not by contract compel filing a petition under Section 83 for the section covers voluntary bankruptcy only. The District and it could not contract jurisdiction out of the Court to require a nondiscriminatory plan. If the contemplated plan of the preliminary contract was unfair, in that it offered too little, it was the R.F.C.'s duty, particularly if it was more than a holder of security, to take more than the plan contemplated or at least to make a waiver of the excess and not try to say the stipulations of its preliminary agreement and not fairness determined the right of a dissenting bondholder.

State law permitted the District to make a contract with the R.F.C. to refund its debts, not to make a contract which would double them. It did not permit a contract that would have allowed the R.F.C. to foreclose on the bonds taken up for a nominal amount and then hold the District for the loan to the extent unpaid and for the amount of the old securities it might buy at the foreclosure sale. It of course took no new state law to permit a private bondholder to accept refunding bonds. A pledge of the debtor's own unsecured debt may give a slightly different remedy, but it is not a weapon for doubling a debt.

49 *Corpus Juris*, p. 903.

Stripped of confusion, this plan said to the dissenting bondholders: *The District is compromising securities. You must sell your bonds to the R.F.C. for 61 cents on the dollar contributed by the District and by the R.F.C.; that the R.F.C. must be treated as having title to all bonds on which it has made advances and*

as qualified to consent and to coerce you into consenting and that for its interest in the bonds it holds and in the bonds you surrender, it shall receive 4 per cent bonds of the District.

The petition makes the resolution of the District which adopted the plan an exhibit of the petition for the purpose of showing the plan of composition. (R. 10 to 18.)

The date of the resolution is December 21, 1938. (See the certification to resolution, R. 19.) (At this date the District and the R.F.C. had received most of the bonds through voluntary transfer.)

At pages 15 and 16 of the record, the resolution states that the District's plan discharges the aforesaid bond and warrant indebtedness by paying thereon 61 cents on each dollar of principal and that these payments are to be accomplished *by the District's* contributing $26,483.12 in cash and through a loan procured from the Reconstruction Finance Corporation amounting to $702,500.00 and that the R.F.C. shall receive 4 per cent bonds which will represent the loan. It is also stated that the R.F.C. is to receive interest at 4% on its advances until new bonds are issued. (R. 17 and 18.)

The reference to the $26,483.12 was in language of the future and it conveys a false impression. It was in no sense the intention to pay to the R.F.C. 2.224% of principal of the bonds and warrants which the R.F.C. had already obtained under the buy-up plan.

As we have suggested, the petition does not reveal that the R.F.C. has already advanced over $600,000.00. That debt is left out of the petition.

If we assume that the R.F.C. intended to hand to the District new money on getting the 4 per cent bonds and that the District was to hand this money back for the $600,000.00 indebtedness we have a form of settling a secured debt. However, it is obvious that one who holds a District's bonds as security in any form is entitled to no more under Section 83 for the bonds he holds than an owner. It would not make a difference insofar as our point is concerned if the petition claimed a secured debt and sought discharge of that. But if that had been alleged, there was possibly some danger in our contention that the District was not bankrupt, was already refinanced.

In fact, as will be shown in the attached brief, it was set out in the original loan arrangement that the R.F.C. would not have the right to receive all the new bonds as against a bondholder who was willing to stand in the same position as was taken by the R.F.C. and, as will be shown in said brief, it was formerly the position of present counsel for this District that the right to receive bonds should under a like loan contract made in the case of another District which they represented be accorded to dissenting bondholders exactly as it was to be accorded to the R.F.C.

As indicated, the petition shows that bonds and warrants to the extent of 90.3% of the whole have already been acquired by the R.F.C. (The resolution, R. 15.)

The District's contribution was 2.224 cents on the dollar or $22.24 per $1000.00 bond and the R.F.C.'s contribution was 58.776 cents on the dollar or $587.76 per $1000.00 bond.

Section 83 of the Bankruptcy Act required that at the time of the filing of the petition the plan should be consented to by creditors holding 51 per cent of the indebtedness involved. The District in fact pleaded that the R.F.C. "now owns and holds not less than 51 per cent, to-wit, more than 90 per cent" of the indebtedness that was to be subjected to the plan. (R. 5.)

The Court specifically found such ownership and that such "owner" had consented to the plan. (R. 103.)

The theory pleaded and found was one of ownership as against dissenting bondholders. We ask the benefit with the burden.

In advancing the 58.776 cents on the dollar the R.F.C. was given a right to call for 4 per cent bonds of the District equivalent to its advances as a condition of surrendering those bonds which passed into its hands *if the District did not pay up what the R.F.C. advanced.* No one disputes that. While times were not fixed, that was the contract. But the contract with its protective provision that permitted the R.F.C. to treat itself as owner is in a Bankruptcy Court and with the R.F.C.'s consent.

The plan enforced is shown precisely in paragraphs III and IV of the District Court's decree enforcing the plan. (R. 121 to 123.)

The petition pleads that the California Districts Securities Commission has approved the District's plan. (R. 6.)

On October 31, 1938, and when the R.F.C. was about to begin the advancing previously arranged, the District entered into a formal written contract to issue to the R.F.C. the 4 per cent bonds. (R. 287.) But here again time of delivery or acceptance was not fixed. The petition in bankruptcy had not been filed.

We go back to the original loan.

By a loan resolution of the R.F.C. dated *May 20, 1938* and set out in the transcript, the R.F.C. granted to the District a loan not to exceed $702,500.00 conditioned upon the District's getting consent of holders of 90% of the bonds and warrants of the District to accept 58.776% of the principal thereof. The loan resolution of the R.F.C. is set out in the transcript. (R. 245 to 271.)

The resolution did not prohibit the District from making a contribution to what the bondholder received.

This resolution made it clear that when 90% or more of debts involved called "old securities" were made available for settlement on a basis that would not require from the R.F.C. over $702,500.00 if all the bonds and warrants were bought up, the R.F.C. would begin advancing the 58.776% on each dollar of principal to anyone who would take that. (R. 248.)

It could refrain from advancing unless 90% of the old securities were made available. (R. 248.)

(In the brief, it will be pointed out that this 90% requirement could be made up in part under an alternative provision. The bonds of bondholders who simply assented to the refinancing were to be counted in the 90%. But really that is not essential to our case.)

Following the adoption of this loan resolution, the District solicited holders to turn over their bonds and warrants to a depository (Bank of America in San Francisco), with instructions to that depository to transfer the securities to the R.F.C. on payment of 61% of principal of these debts. The escrow instructions to be signed by the bondholders are set out in the record. (R. 355 to 359.)

Petitioner's Exhibit No. 13 shows the advances made by the R.F.C. up to June 12, 1939 (covering the period prior to and after filing of the petition) were as follows:

Nov. 29, 1938	$630,097.98
Dec. 5, 1938	2,241.95
Jan. 27, 1939	1,175.72
April 26, 1939	2,938.80
Total	$636,454.25

(R. 278.)

This conforms to the interest bill which the R.F.C. sent to the District. (R. 361.)

The oral testimony was that on November 29, 1938 on the day the R.F.C. made the large advance, the

District placed with Bank of America in San Francisco, the 2.224% of principal of the debts bought up and that the balance of the payment of 61 cents or 58.776% of the principal was put up by the R.F.C. (R. 153, 161.)

The resolution stated that if the District paid the R.F.C. its advances, it could have back the old securities but that even this would not discharge those securities. (R. 258 and 259.)

Again the R.F.C. might call for 4 per cent bonds equal to the amount of its advances. (R. 260.)

But times of performance were not fixed.

The loan resolution provided:

> "(g) In the event that the Borrower shall institute legal proceedings for the purpose of subjecting its outstanding Old Securities to a plan of refinancing, the Division Chief and Counsel *may* give such approval and consents that may be required to subject the Old Securities then held by or on behalf of this Corporation to any such plan which may be satisfactory to them and which will not result in the holders of any Old Securities receiving payments or benefits therefor in excess of what they would have received if such Old Securities had been voluntarily deposited as herein provided." (R. 261.)

We quote further:

> "Until such Old Securities have been exchanged for New Bonds, all such securities as well as all rights in or to the same shall continue to be and constitute obligations of the Borrower for the full

amount thereof and nothing in the Resolution shall be deemed to limit the right of this Corporation to enforce or cause to be enforced full payment of principal and interest of such Old Securities as when the Division Chief and Counsel shall deem it advisable to do so;" (R. 258.)

Thus the R.F.C. safeguarded against advantage to dissenting bondholders from the fact that the bonds were taken up at a discount.

The District accepted the resolution on June 8, 1938. (R. 271.)

We concede for the purpose of the case that the District stood menaced on January 1, 1939 with its entire bond debt and that as against petitioners the part of the debt bought up was "owned" by the R.F.C.

That is the theory of the case. But certainly the instant the R.F.C. said: We elect to vote our bonds; we select the bankruptcy remedy thereon, its rights therein were subject to Section 83.

THIS COURT HAS JURISDICTION.

Judicial Code, Section 240(a);
28 *U. S. C. A.,* Section 347(a);
Magnum Import Co. v. Coty, 262 U. S. 159, 43 S. Ct. 531, 67 L. ed. 922.

The brief will follow.

WHEREFORE, petitioners respectfully pray the writ of certiorari issue out of and under the seal of

this Honorable Court, directed to the Honorable Circuit Court of Appeals for the Ninth Circuit in San Francisco, requiring that Court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all proceedings in the case numbered 9591 on its docket and entitled "J. R. McDonald, J. R. Mason and Mary E. Morris, Appellants v. Banta Carbona Irrigation District, Appellee" and that the said decree of said Court may be reversed by this Honorable Court and that your petitioners may have such other relief in the premises as to this Honorable Court may seem meet and just.

Dated, Berkeley, California,
February 27, 1942.

J. R. McDonald,
J. R. Mason,
Mary E. Morris,
Petitioners.

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